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MANUFACTURERS HANOVER

Financial Digest

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Analysis of Business Trends Plus Selected Financial Indicators

The Outlook For Monetary Policy

Despite the virtual certainty that the pace of business slowed decidedly in the first quarter, the financial markets have grown concerned that the economy remains strong enough to boost both the inflation rate and interest rates. According to this view, the days of an accommodative Federal Reserve monetary policy are numbered as well, for the combination of rapid economic growth and rising inflation may have prompted the central bank to move the policy dial from ease back to restraint. In this environment, the announcement that the nation's unemployment rate dipped to a nine-year low in March while payroll employment increased by better than 260,000 further fanned market jitters. The bond market extended the selloff which got underway early last month, pushing up long-term Treasury yields by about half a percentage point.

While it is possible to cobble together a case for rapid economic growth and higher inflation rates, the bond market seems to be overlooking some evidence to the contrary. Take, for example, the March employment report. The markets focused almost exclusively on the dip in the unemployment rate to 5.6 percent and another hefty increase in payroll employment–a combination suggesting the specter of a rapidly expanding economy, rising inflation and, of course, a tightening of monetary policy. All but ignored were several less impressive elements of the employment report which tended to at least call into question the view that the economy will soon "overheat", and that the inflation rate will spike higher.

For one thing, manufacturing employment actually fell slightly in March, the first drop in factory jobs since last June. To be sure, while a large part of the decline was attributable to lumber industry layoffs, which could be reversed in the current quarter if homebuilding perks up, the March result is hardly an aberration, but rather the continuation of a trend underway since the end of last year. Employment gains averaged about 12,000 monthly in the first quarter of this year–well below the 61,000 monthly average increase posted in the latter half of 1987.

For another, this trend has tended to put a damper on wages. In the first quarter, average hourly earnings in manufacturing were just a shade higher than in the fourth quarter, and up only two percent over the past year. In light of recent productivity gains, which have been especially pronounced in the industrial sector, labor costs per unit of output are rising only slowly, corralling a key prerequisite for a higher rate of inflation.

Finally, the dip in factory jobs in March, combined with the reported drop in the average workweek, make it a good bet that industrial production remained sluggish last month. Plainly, this is not a favorable sign for an economy which is counting on stronger industrial production to keep it out of recession this year. With output growth slowing, the rapid climb in industry operating rates–which lifted capacity utilization in manufacturing to its highest level in nine years–has also paused, easing the threat of capacity bottlenecks, and higher inflation rates.

Tunnel Vision In The Bond Market

While these components of the March employment numbers may be ignored by the bond markets, they should not be by the Federal Reserve. Nor will such other features of the economic environment as the renewed slippage in consumer confidence in March, the subdued pace of consumer spending, the two-month drop in factory orders and the lethargic pace of new construction–not to mention the fact that on the inflation front, too, the perception seems much worse than the reality.

Productivity growth, for example, has outrun wage growth, yet the bond market has begun to fear a wage-driven inflationary spiral. A 3½ percent rise in industrial commodity prices between end-February and end-March has stirred fears of a commodity-driven price spiral yet, overall, industrial

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commodity prices are no higher now than they were last October. And a softer dollar due to speculative selling pressures in front of the March 31 end of Japan's fiscal year prompted concerns of an import-driven price spiral–despite the fact that the dollar remains well above its yearend 1987 lows (Financial Digest–March 28, 1988) and is now being bolstered by a perception of central bank intervention, along with a rapidly improving trade balance.

The central bank cannot afford to ignore this evidence and suffer the same type of tunnel vision as the bond market. If it does, it runs substantial risks. A switch toward restraint, based upon a misreading of either current business conditions, inflation rate prospects or the perceived vulnerability of the dollar, would not only place this economy's health in jeopardy, but that of the global economy as well.

On the other hand, the likelihood of a more accommodative policy seems remote–despite the fact that money growth remains well-behaved, if not downright sluggish, while short-term business credit demands are

Short Term Paper Outstanding
(Millions of Dollars)

Time Deposits of $100,000 or more Weekly Reporting Banks	Latest Week	Change Since Week Ago	Change Since Year Ago
Nationwide (3/23/88)	183,040	– 98	+ 14,479
New York City (3/30/88)	37,780	– 419	+ 1,899
Commercial Paper (3/30/88)	388,794	– 3,264	+ 52,540

Bank Loans
(Millions of Dollars)

Commercial and Industrial Loans

Weekly Reporting Large Commercial Banks	Latest Week	Change Since Week Ago	Change Since Year Ago
Nationwide (3/23/88)	291,293	– 1,066	– 1,203
New York City (3/30/88)	55,451	+ 479	– 7,431

Total Loans and Leases Gross Adjusted

	Latest Week	Change Since Week Ago	Change Since Year Ago
Nationwide (3/23/88)	967,804	+ 100	+32,566
New York City (3/30/88)	172,750	+ 2,551	–33,049

Financial Markets

	Friday 4/8/88	Change Since Week Ago	Change Since Year Ago
U.S. Governments, Closing Yields:			
90-Day Bills†	6.19%	+ .33	+ .21
180-Day Bills†	6.45	+ .16	+ .24
Longest Bills†	6.93	+ .18	+ .41
Recent Issues:			
7 3/8S 3/31/90	7.43	+ .07	
7 7/8S 3/31/92	7.88	–0–	
8 1/8S 2/15/98	8.50	– .03	
8 7/8S 8/15/17	8.69	– .06	
Municipals:			
Bond Buyer–20 Bond Index* (4/7/88)	7.80%	– .10	+ .53
Blue List Total ($ Million)	$1,023	– $ 42	–$1,655
30-Day Visible Supply ($ Million)	$2,776	+ $106	–$ 618
Total	$3,799	+ $ 64	–$2,273
Corporates:			
Moody's Aa Composite (4/7/88)	9.80%	+ .05	+ 0.88
30-Day Visible Supply ($ Million)	$2,269	+ $320	–$3,854
Stocks:			
Dow-Jones Averages:			
Industrials	2,090.19	+ 102.13	–248.59
Transportation	883.66	+ 20.61	– 66.60
Utilities	176.56	+ 5.09	– 27.78
65 Stocks	781.40	+ 30.53	– 88.73
N.Y.S.E. Composite Index	152.03	+ 5.43	– 13.69
N.Y.S.E. Avg. Daily Vol. for Week (000's)	170,886	+ 23,881	– 7,731

*34% Taxable equivalent 11.82%.

† Bond equivalent.

International Rates

EURODOLLAR DEPOSIT RATES (bid)	Friday 4/8/88	Week Ago
Overnight	6.75%	6.48%
1 month	6.94	6.75
3 month	7.00	6.88
6 month	7.19	7.13
1 year	7.63	7.50

EURODOLLAR BONDS Average Yield		
Medium Term (5 yrs.)	9.18%	10.12%
Long Term (10 yrs.)	9.18	10.12

FOREIGN EXCHANGE SPOT RATES New York Opening (4/8/88)	Currency Per U.S. $	Week Ago
Canada	1.2465	1.2347
France	5.6910	5.6190
Germany	1.6745	1.6578
Italy	1242.40	1229.80
Japan	125.58	124.23
Mexico	2273.00	2273.00
Switzerland	1.3850	1.3650
U.K.*	1.8713	1.8830

*U.S. $ per U.K. pound

MH TRADE-WEIGHTED DOLLAR (4/8/88) (Adjusted for Inflation)	Change Since Week Ago	Change Since 2/27/85
	+0.9%	–2.8%

lackluster at best. Until the extent of the business slowdown becomes evident, any easing of monetary policy also runs the risk of fanning today's inflation expectations, and undermining the dollar overseas.

Has The Fed Tightened?

In this environment, the best policy approach might be to stand pat for now, and await more convincing evidence as to the direction of both the economy and the rate of inflation. Although speculation is rampant among those who follow closely every wiggle in the Federal funds rate that policy has already been firmed, it may be too early to tell.

This is because it's tax season, and around this time of year Treasury balances swell and bank reserves diminish as April 15, the deadline for the payment of individual income taxes, approaches. A rise in short-term interest rates at this juncture, which could eventually prompt a boost in the prime rate, could have more to do with the calendar, than with deliberate central bank actions. ■

Selected Federal Reserve Data

(Averages of Daily Figures—Billions of Dollars)

	Week Ending 4/6/88	$ Change Since Week Ago	$ Change Since Year Ago
Reserve Bank Credit			
U.S. Gov'ts and Agencies Owned Outright & RPs	224.811	+ 2.087	+17.850
Loans to Depository Inst.	3.169	+ .704	+ 2.578
Float	1.744	+ 1.243	+ 1.075
Total Reserve Bank Credit	244.557	+ 3.989	+19.125
Treasury Deposits with Federal Reserve Banks	3.554	+ .986	− .369
Currency in Circulation	227.560	+ 1.852	+13.684
Gov'ts held for Foreign Acct. by F.R. Banks (End-of-Week)	228.237	+ 2.788	+49.994
	4/6/88		
Member Bank Reserves:			
Total Reserves Held	58.394	+ .578	+ 1.638
Excess (Deficiency)	.884	− .023	+ .205
Net Free Reserves	.561	− .117	+ .275

Monetary Aggregates †		% Change Since‡ 3 Months Ago*	% Change Since‡ Year Ago
M1 (3/28/88)	768.3	+ 6.6	+ 3.8
M2 (3/28/88)	2,979.5	+ 9.3	+ 4.7
M3 (3/28/88)	3,746.7	+ 8.3	+ 5.8
Domestic Nonfinancial Debt (4th Q'87)	8,361.5	+ 10.2	+ 10.0

† Seasonally adjusted.

* Seasonally adjusted annual rate.
‡ Four-week moving average.

New York Money Market

Offering Rates 4/8/88	3 Months	6 Months	1 Year
‡U.S. Treasury Bills	6.02%	6.18%	6.53%
* Federal Agencies	6.64	6.66	6.75
* Municipal Notes—High Grade (34% Taxable Equivalent)	6.36	6.67	6.97
Negotiable Time CDs Manufacturers Hanover	Rates By Arrangement		
* Secondary Market—Prime	6.90	7.10	7.40

‡Finance Company Paper—Prime

5- 14 days	6.70%
15- 29 days	6.70
30- 59 days	6.73
60- 89 days	6.75
90-179 days	6.75
180-239 days	6.65
240-270 days	6.65

‡* Bankers' Acceptances

May	6.70%
Jun.	6.71
Jul.	6.73
Aug.	6.78
Sep.	6.80
Oct.	6.80

‡Industrial Paper—Prime

30- 89 days	6.75%
90-120 days	6.80

†Federal Funds Effective Rate 6.90%

‡Discount basis. *Subject to availability. † Estimated.

Selected Business Indicators

(All Dollar Figures in Billions)

	Latest Period or End of Period		Previous Period	Year Ago Period
Gross National Product (Current Dollars)*	4th Q'87	$ 4,607	$ 4,524	$ 4,288
Gross National Product (1982 Dollars)*	4th Q'87	$ 3,881	$ 3,836	$ 3,732
Percent Change, Annual Rate	4th Q'87	4.8	4.3	1.5
Change in Consumer Prices*	Feb '88	2.4%	3.6%	4.8%
Change in Producer Prices*	Feb '88	− 2.4%	4.8%	2.4%
Civilian Employment (Thousands of Persons) †	Mar '88n	114,103	114,409	111,455
Unemployment as % of Civilian Labor Force†	Mar '88n	5.6%	5.7%	6.5%
Personal Income*	Feb '88	$ 3,914	$ 3,880	$ 3,671
Leading Indicators Composite Index (1967=100)†	Feb '88n	190.6	188.9r	186.0
Industrial Production Index (1977=100) †	Feb '88	134.4	134.2	127.1
Net Change in Consumer Installment Credit †	Feb '88n	$ 5.30	$ 6.24r	$ 1.01
U.S. Merchandise Trade Balance	Jan '88	−$ 12.44	−$ 12.20	−$ 11.94
Plant and Equipment Expenditures*	1st Q'88	$427.97(a)	$417.25(a)	$374.23
Private Housing Starts (Thousands of Units)*	Feb '88	1,494	1,372	1,809
New Construction Expenditures*	Feb '88n	$ 391.5	$ 392.5r	$ 401.6
Total Business Inventories †	Jan '88	$ 705.9	$ 702.9	$ 659.2
Total Business Sales †	Jan '88	$ 462.8	$ 466.1	$ 425.0

*Seasonally adjusted annual rate. †Seasonally adjusted. n-Newly reported figure. r-Revised. a-Anticipated.

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Vitality

"...We look for stronger operating earnings in 1988 based on three fundamentals—further success in managing our businesses for higher returns, lower operating expenses and a continued improvement in credit quality..."

Extracted from a letter to shareholders by the Chairman, John F. McGillicuddy.

"...Restoring common shareholders' equity to four percent, the ratio prior to the reserving action, is our overriding priority. We intend largely to accomplish this objective by the end of 1988 through a combination of gains from the sale of undervalued assets, the realization of tax benefits resulting from the addition to the reserve, and stronger operating earnings.

Asset Sales

"During 1987, as part of the equity restoration process, we realized $150 million pre-tax from the sale of undervalued assets. We continue to have substantial amounts of undervalued assets on our books. By selling a portion of them, we anticipate pre-tax gains in 1988 of $400 million—$230 million after-tax, but before tax benefits relating to the reserve decision.

Tax Benefits

"In 1987, the full impact of the reserving action was mitigated by the ability to apply $277 million in tax benefits. In 1988, we will have the capacity arising from operating earnings and gains from asset sales to apply approximately $200 million of the remaining $342 million of tax benefits relating to the reserve action.

Operating Earnings

"While tax benefits and special gains will be essential to rebuilding equity in 1988, it is the renewed strength of our basic businesses that will make the major difference this year and in the years ahead.

"We look for stronger operating earnings in 1988 based on three fundamentals—further success in managing our businesses for higher returns, lower operating expenses and a continued improvement in credit quality as was evident in the fourth quarter of 1987.

"Manufacturers Hanover has strong franchises in play within profitable segments of three key markets.

"Also in place is an effective profitability discipline to make these businesses pay off in higher returns. It proceeds from the logic that managing for higher returns dictates that we exit, sell or downsize businesses that no longer meet our targets while directing additional resources to the most profitable segments of our markets. The objective is clear—to enhance shareholder value.

"Managing for higher returns formed the basis of the restructuring and other special charges we took in the fourth quarter amounting to $417 million. This primarily related to the exiting of businesses, a further sharpening of focus in selected markets, the closing of domestic offices and a planned staff reduction of approximately 2,500. With this reduction, total staff will have been scaled down by approximately 5,400 positions, or 17 percent, since the beginning of 1986.

"The restructuring portion of the fourth quarter charges amounted to $82 million, but will result in an earnings benefit going forward of approximately $95 million a year.

"Improved results were largely masked in 1987 by the reserving action in June and the fourth quarter restructuring charge. Progress was broadly based. For example, trading revenues increased 97 percent to $161 million. Earnings from consumer banking increased 22 percent to $116 million. Net income for the Corporate Banking Sector totalled $166 million, up from $90 million in 1986.

"Also masked was our institution's continued success in controlling overhead. Without the restructuring and other special charges, operating expenses would have been up only 3.3 percent for the year—among the best performances for a money center bank. Expense control remains an imperative. We expect operating expenses in 1988 to be lower than last year's level.

"In summary, with a number of major restructurings behind us, the real value of our business franchises will begin to be reflected in stronger operating earnings."

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